

OFFICE OF THE STATE CONTROLLER
1998 CAFR FOOTNOTES
CASH AND INVESTMENTS— C-10 WORKSHEET (CONTINUED)

Glossary of Selected Key Terms

Collateralized - The underlying mortgage-backed securities backing a CMO deal.

Collateralized Mortgage Obligations (CMO) - A security created using the underlying cash flows from mortgage-backed securities as collateral. A CMO shifts the uncertainty regarding the exact timing of principal return in a mortgage-backed security. This uncertainty exists because the timing of mortgage principal payments is influenced by changes in interest rates, the current economic climate, and the geographic makeup of loans.

Credit Risk - The likelihood that a party involved in an investment transaction will not fulfill its obligations. This type of risk is often associated with the issuer of the investment security and is affected by the concentration of deposits or investments in a single instrument or with a single institution.

Derivatives - Financial arrangements whose returns are linked to, or derived from, some underlying stock, bond index, commodity, or other asset. They come in two basic types: options and “forward-type” derivatives, which include forwards, futures, and swaps. They may be listed on exchanges or negotiated privately between institutions.

Derivative Securities - Trade like normal bonds, but their returns are determined by, or derived from, factors other than plain interest rates. For instance, returns on “structures notes” may vary in line with changes in stock prices, commodity prices, foreign exchange rates, or two different interest rates. Return on mortgage derivatives involve bets on the rate at which homeowners will repay mortgages, and often act like leveraged interest rate options.

Extension Risk - Possible illiquidity of an investment due to a change in interest rate that slows down prepayments. The investor may have to hold the investment longer than originally intended to recover the amount invested.

Floater - A CMO class created from fixed rate mortgage backed collateral whose coupon adjusts on a monthly basis versus a market index.

High-risk - A type of security deemed unsuitable for specified investors by certain regulatory agencies.

Index - A benchmark measure of interest rates used in calculating coupons on adjustable securities.

Interest Only - A security whose payment represents the coupon payments on the outstanding principal balance of the underlying mortgage-backed security collateral and pays no principal.

Inverse Floater - A CMO class whose coupon adjusts opposite to the changes in a market index.

Interest Rate Risk - The risk that longer-term fixed income stocks will drop in market value if general interest rates climb or the risk that interest rates will change above current levels on a locked-in or fixed rate instrument.

Legal Risk - The possible financial loss resulting from an action by a court or by a regulatory or legislative body that could invalidate a financial contract.

Market Risk - The risk that the market value of an investment, collateral protecting deposits, or securities underlying a repurchase agreement will decline. This type of risk is affected by the length to

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maturity of a security, the need to liquidate a security before maturity, the extent that collateral exceeds the amount invested, and the frequency at which the amount of collateral is adjusted for changing market values.

Mortgage-backed Securities - The securities are structured by pooling together standardized residential mortgage loans of similar characteristics. The investor purchases a pro-rata share of the interest and principal that the borrowers pay on the mortgage loans in the pool.

Negative Convexity - Measure of how prices react to changes in interest rates. Many CMOs are negatively convex, which means that when interest rates are falling, the price of the CMO may not rise as rapidly as a Treasury bond with equivalent coupon and maturity. When interest rates rise, the CMO may experience more severe price declines than the equivalent Treasury bond. Negative convexity is the result of changes in how quickly or slowly the principal of a CMO is being paid. Changes in the speed of principal payments are a function of how quickly the mortgages that make up the bond collateral are paid off, either through refinancing or home sales. Investors who have adequate information about the degree of negative convexity of a security will demand protection from this risk in the form of a discounted price.

Prepayment Risk - The risk associated with the extension or contraction of principal repayments in a pooled mortgage security. Prepayments of any loan in the mortgage pool by a borrower will shorten the average life of the security and also affect the yield. As interest rates decline, the borrowers are more likely to refinance their mortgage into a lower rate loan.

Principal Only - A security whose payment represents the principal stream of cash flow from the underlying mortgage-backed collateral and bears no interest rate.

Tolerable Risk - The level of risk an entity is willing to accept without regards to the potential returns. Only investment activity below this threshold will be undertaken. Tolerable risk should be established when the entity outlines its investment objectives.

Tranche - A security class of a CMO deal.

Volatility - The relative impact of changing interest rates in general market conditions on an investment.

Weighted Average Life (WAL) - The average amount of time the principal balance of a mortgage pool is outstanding.

Yield - The annual return on an investment (from dividends or interest) expressed as a percentage of either cost or current price.

Yield to Maturity - Refers to the yield of a bond also taking into account the premium or discount of the bond.

Z-Bond - This tranche of a CMO is similar to a coupon bond. Rather than receiving interest, it is reinvested at the coupon rate of the security. Z-bonds are generally the last tranche in a pool of collateralized mortgage obligations.